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The Islamization of the Economy and the Development of Islamic Banking in Pakistan*

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1. Introduction

The primary purpose of this work is to analyze the efforts that have been made and measures that have been taken to Islamize the economy, specifically the banking and financial institutions in Pakistan. This analytical study is thematically composed in four major sections. Section 1 explains the objectives and purposes of the study. In Section 2, we make a step by step examination of the nature, effectiveness and implications of strategic policies and measures taken to Islamize banking and financial institutions prior to the historic judgment of the Lahore High Court that the Islamic *Shariah* was the supreme law of the land. After evaluating these measures we point out some of the factors that have hindered the Islamization process in Pakistan. In Section 3, we examine the strategies and efforts made to re-launch the establishment process of Islamic banking after the judgment of the Supreme Court. The contemporary picture of Islamic banking in Pakistan and the factors that support the successful development of Islamic banking are also described in this section. Finally, Section 4 concludes the study; we express some future expectations about Islamic banking and recommend some directions for the development of Islamic banking, relatively new economic phenomena.

2. A Historical Perspective of Islamization Measures Taken Prior to the Judgment of the Supreme Court

Islam was the basis for demanding a separate and independent country within the British ruled Indian sub-continent. The freedom movement of Pakistan was based on the two-nation philosophy, which stated that the Hindus and Muslims of India were two different nations each having her own religion, customs and lifestyle. Pakistan was created so that its people could live according to Islamic teachings and principles.

Today the world is beginning to recognize the significance of the Islamic finance industry, but in Pakistan the importance of adopting an Islamic economic system was stressed soon after its independence sixty years ago. Muhammad Ali Jinnah (Founder of Pakistan) emphasized the virtues of Islamic principles. In his historic address at the inauguration of the State Bank of Pakistan on July 1st, 1948, he said:

I shall watch with keenness the work of your organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work towards our destiny in our own way and present to the world an economic system based on the true Islamic concept of the equality of manhood and social justice.

Soon after the independence several strategic measures, both at constitutional and institutional levels were taken for the inducement and implication of Islamic principles in the state affairs. In

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following sub-sections we will examine these measures in a gradual order.

2.1 Measures Taken in the Constitutional Arena to Introduce Islamic Provisions

Islamic activists have struggled for a long time for the inducement of Islamic commands in the state affairs and for the elimination of interest from the economy. But their efforts have been stymied mainly by Pakistan's political system. The first Constituent Assembly, which was created under the Indian Independence Act of 1947, adopted the Objective Resolution on March 12th, 1949. The Objective Resolution envisaged clearly that "*Pakistan will be a state wherein the Muslims of Pakistan shall be enabled to order their lives in accordance with the teachings and requirements of Islam as set out in Holy Qur'an and Sunnah*". Article 28 of the 1956 Constitution, made it obligatory for the government to eliminate interest from the country "as early as possible" and the 1962 Constitution called for the abolition of interest. Along with these provisions, Article 2 of the 1973 Constitution stated that Islam is the state religion of Pakistan and Articles 2A, 31, 37, 38(F), 227 of the constitution made it obligatory for the government to take steps to enable the Muslims of Pakistan to order their lives in accordance with the injunctions of Islam. Therefore, it was expected that living in Pakistan would be according to the teachings and commands of Islam. Other constitutional institutions for the inducement and implementation of Islamic teachings in the economic and other sectors of the country are the Council of Islamic Ideology (CII) and the Federal Shariah Court (FSC) of Pakistan. The Council of Islamic Ideology was established in 1962 for the purpose of advising the government about bringing its laws and provisions into conformity with the injunctions of Islam. The council has the following functions:

1. To recommend laws conforming to Qur'an and *Sunnah* to the federal and provincial assemblies.
2. To advise the parliament, the government, the president or a governor on any question referred to the council as to whether a proposed law is or is not repugnant to the injunctions of Islam.
3. To make recommendations for bringing the current laws into conformation with Islamic injunctions.
4. To compile guidance for parliament and provincial assemblies.

CII made numerous recommendations during the 1960's that interest should be eliminated in Pakistan as it is forbidden by *Shariah*. In 1971 CII presented a report to the government that recommended the abolition of interest [CII 1983: 10]. In 1976, the Council of Islamic Ideology amended its questionnaire of 1966, regarding the dilemma of interest, and mailed it to well-known Islamic scholars, Islamic laureates, economists and researchers of the State Bank of Pakistan and to economic organizations in other Muslim countries. After a long time consumed research, the council prepared a set of recommendations and sent to the government of that time. These recommendations do not appear to have been subjected to any formal public debate in parliament by the regime of Zulfikar Ali Bhutto. In 1977, CII was entrusted by the next president of Pakistan, Zia-ul-Haq, with the task of preparing a blue print for making the economy interest-free. The president

directed the Council on September 29th, 1977 to consider how best to “eradicate the curse” of interest, and so the issue of interest or *riba* gained central issue in country’s policy arena [Charles H. Kennedy 2004: 102]. The Council of Islamic Ideology (CII) appointed a panel of economists and bankers in November 1977 to assist the council in the delicate task of finding ways and means to eliminate interest from the financial institutions and re-model (Islamize) Pakistan’s economy [CII 1983 (2000): xiv]. CII submitted a number of reports and made several recommendations to transform the socio-political and economic system into a system confirming to the tenets of the *Shariah*. Some noteworthy developments around this period are as followings [Hussain 2006]:

1. In 1979, two government-owned mutual funds in Pakistan, the NIT and ICP, started to eliminate interest from their operations by eschewing investment of their funds in interest bearing securities. ICP’s investor scheme was replaced by a new one based on profit and loss sharing from October 1st, 1980.
2. The state-run House Building Finance Corporation (HBFC) also eliminated interest from its operations from July 1st, 1979.
3. In June 1980, legal framework was amended to permit the issuance of a new, interest-free instrument of corporate financing called a Participation Term Certificate (PTC).
4. The introduction of *zakat*, which refers to an annual tax on surplus wealth obligatory in Islamic law, in June 1980. After its implementation by the Supreme Court of Pakistan it was called the *zakat* Ordinance.
5. A new law, namely, the *Mudarabah* (a specific business tie of islamic finance similar to profit sharing,) Companies and *mudarabah* Ordinance of 1980 along with the *mudarabah* Companies and *mudarabah* Rules of 1981 was promulgated to introduce *mudarabah* as a two-tier fund structure, for undertaking *Shariah* compliant business transactions.
6. The introduction of the *Usher* (a form of charitable investment where a percentage of each donator’s income is accumulated to help needy peoples) Ordinance in March 1983.
7. In 1984, the Banking and Financial Services Ordinance amended seven laws and the Banking Tribunals Ordinance of 1984 provided a new system of recovery for non-interest based modes of financing.
8. From January 1st, 1981, separate interest-free counters started operations in all the nationalized commercial banks to mobilize deposits on a profit and loss sharing basis. Concurrently, banks were prohibited from specified interest based transactions, which resulted in the development of Islamic modes of financing.
9. The SBP issued BCD Circular No. 13 of 1984 called for the elimination of *riba* from the banking system and on January 1st, 1985 all financing to Federal and Provincial Governments, public sector corporations and public or private joint stock companies were directed to do business only through interest-free modes.
10. From July 1st, 1985 all commercial banking in Pak Rupees was declared interest free and all deposits were operated on a profit and loss sharing (PLS) basis.

11. Specialized financial institutions were allowed a transitional period from July 1979 until July 1985, and commercial banks were given from January 1981 until July 1985, to eliminate interest from their operations. All nationalized commercial banks opened a special counter in 7000 domestic branches for accepting deposits on the basis of Profit and Loss Sharing (PLS) in 1981 [Zaidi 1988: 23; Zubair 1987: 15].

2.2 Measures Taken at the State Bank of Pakistan

During the first decade of the establishment of the State Bank of Pakistan, no substantive research work could be done for the promotion or development of an Islamic economy [State bank of Pakistan as there was no economist in the country well acquainted with both the basic principles of Islamic fiqh and contemporary economics [State Bank of Pakistan 2000: 609]. In 1963, the State Bank prepared a comprehensive note for the benefit of the Council of Islamic Ideology (CII) on various issues related to the problem of *riba*. The council gave its views in 1969, stating that modern “interest” falls under the definition of *riba* and therefore must be abolished from all banking and financial institutions. In 1978, the Islamic Economics Division of the State Bank of Pakistan completed an in-depth study of various ingredients of the Islamic financial system including *mudarabah*, *shirkah* (*shirkah*, *shirakah* or *musharakah*: a specific device of Islamic finance similar to Joint venture), *salam* (a specific financial mode of Islamic finance where the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The price is in cash but the supply of purchased goods is deferred), *murabahah*, *zakat* & *usher* and other related issues. This Division served as the hub of the national effort to mark out an overarching financial system compliant with *Shariah* principles. It served as the secretariat of the meetings of the Council of Islamic Ideology (CII), the Panel of Economists and Bankers, and six special work groups that were entrusted with the job of hammering out the details for transforming the financial system.

2.2.1 Formation of Special Working Groups at the State Bank

In a meeting on the April 8th, 1979, six work groups were formed to study in-depth the issues for the abolition of *riba* and to transform the financial institutions. These work groups were to cover the following fields of finance:

- (1) Government transactions.
- (2) State Bank of Pakistan: Domestic transactions and bank monetary policy.
- (3) Bank deposits, Inter-Bank relations and bank management.
- (4) Loans for fixed investment in industry, agriculture, construction, etc.
- (5) Financing of working capital requirements.
- (6) Co-operative credit system.

In February 1980, the Panel of Economists and Bankers, established under the supervision of the State Bank of Pakistan, gave its detailed final report which was submitted to the government, through the CII, in June 1980. This report prescribed a time frame, according to which the process

of eliminating interest in Pakistan was to be completed by July, 1982.

2.2.2 Development of Permissible Modes of Finance

For conducting Islamic banking operations in practice, the State Bank of Pakistan issued its Circular No. 13; dated June 20th, 1984 and approved the following twelve modes of finance to be used by all banks carrying out banking activities in Pakistan. These financial techniques or modes can be classified into three categories:

- A. Trade related/type modes of financing
 - 1. mark-up/cost plus sale
 - 2. mark-down
 - 3. buy-back
 - 4. leasing
 - 5. hire-purchase
 - 6. development charges
- B. Investment related/type modes of financing
 - 1. *musharakah*
 - 2. equity participation
 - 3. participation term certificate (PTCs)
 - 4. rent sharing
- C. Loan related modes i.e. financing by lending
 - 1. loans carrying service charges
 - 2. *qard-ul-hasan* (beneficiary loan)

2.3 Implementation of the Above Measures and Practices by Banks: an Analytical Overview

The Council of Islamic Ideology (CII) has pointed out that the ideal alternatives to interest in an Islamic economic system are *musharakah* and *mudarabah* (participation in profit and loss) modes of finance along with *qard-ul-hasan*. However, keeping in mind the difficulties in the practical application of the system of profit and loss sharing in certain spheres it endorsed the recommendations of the Panel of Economists and Bankers that certain other modes like leasing, hire purchase and *bai muajjal* (a sales contract, where the bank buys a commodity at a lower price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments at higher price than cost) on the basis of actual operating results might also be used in interest-free banking operations, while cautioning against the danger that these modes could be misused as a means for opening a back door for interest. Evaluating the practice of conventional banks in terms of compatibility with the Islamic *Shariah*, the following facts were confirmed [Rahman 197: 8]:

- 1. Interest-free counters were operating on the previous interest bearing basis.
- 2. Deposits received were used on the basis of 'mark-up' and 'mark-up over mark-up' that were similar to interest.

3. Saving Schemes (e.g. Special Deposits, National Certificates, Monthly Income Certificates, Participatory Term Certificate, etc.) based on interest were more attractive than interest-free modes of investment.
4. A number of features of the *musharakah* agreement were in conflict with the *Shariah*.
5. Interest had been labeled as 'Profit', and the depositors under the Profit and Loss Sharing (PLS) were neither informed in which venture their money had been invested, nor was a separate balance sheet of their accounts prepared. The methods of calculating profits on PLS accounts were also not indicated. On the analogy of interest bearing accounts, a greater margin of 'profit' was offered on deposits of longer duration.

The underlying principle behind the opening of separate interest-free counters in banks besides or along with interest bearing counters was itself objectionable as it tended to give the impression that *riba* was something to be avoided by only the pious Muslims, whereas the illegality of *riba* is applicable to all Muslims irrespective of their degree of piousness.

It also transpired from this study of banks that they provided more than 80% of the financing under the 'buy-back' agreement with mark-up in price [Inayat 1993: 43]. The mechanism for conducting a mark-up transaction is similar to that followed under the interest based system. It is unfortunate to note that despite the fact that mark-up as a device was only to be used in unavoidable cases, it had been made the pivot of the new arrangements. It is also important to note, that the government is still mobilizing resources from the public through the National Saving Scheme on a fixed return basis by merely changing the name of return from 'Interest' to 'Profit'.

One can easily infer, from the 'interest-free' banking experience of Pakistan, that other than a change in terminology (the term 'interest' was merely replaced with the term 'profit') the actual practice had remained similar to the previous interest-based banking methods in government-owned conventional banks in Pakistan [Inayat 1993: 43]. It is clear that the steps taken by the government to eliminate interest from the country's economy have proved to be spotty and uneven. Justice Tanzil-ul-Rehman, Chairman of Council of Islamic Ideology has commented that the whole approach has been characterised by "dualism and half heartedness".

The Islamization of banking and financial institutions suffered a serious setback in August 1985, when banks were allowed to invest their Profit & Loss Sharing (PLS) deposits in interest-bearing government securities. The ultimate earnings from these investments (PLS deposits) obviously contained a substantial element of interest. Since 1984-85, the government has not introduced any policies regarding the elimination of interest from governmental transactions [Ahmed 1994: 73].

The second serious weakness in this process was the absence of a proper constitutional mechanism (SBP started to take serious steps towards the development of Islamic banking from the year 2001) for the continuous monitoring of *Shariah* compliance, the security of the bank/customer relationship and legislative supervision of Islamic banking operations. Individual scholars have pointed out several deviations in the *musharakah* and Diminishing *musharakah* modes of finance, where the actual banking practices showed deviations from *Shariah* compliance. Even in the sound

idea of issuing Participatory Term Certificates (PTCs), no legislative framework was provided for standardizing the features of this financial instrument to ensure *Shariah*. The CII report had provided a broad outline of the features of such financial instruments but the actual form in which PTCs had actually been issued did not fully conform to the suggested outline.

Among the 12 permitted modes of financing, ‘mark-up’ was the most popular. It took two forms; (a) a client asks the bank to purchase a particular item for him, the bank purchases the item and then sells it to the client at higher price payable in the future; (b) the buyer pays back the agreed price in installments until the transaction is completed. The second form of above transaction, where the buyer pays an agreed price, involves a buy-back (interest-based) agreement. Regarding this form of transaction, there was no corresponding change either in the legal or regulatory framework of the bank; no consequent procedures or bank operations were changed. The only change was a superficial one, a mere change in nomenclature, the term ‘interest’ was replaced either by the terms ‘service charges’, ‘mark-up’ or ‘profit’ [Hassan 2002].

The scholars of *Shariah* and the Federal Shariah Court itself have criticized the above practice. It is remarkable that even though *mudarabah* and *musharakah* are the ideal substitutes for interest, no particular attempt had been made to incorporate these modes into financial transactions.

2.4 Judgments of the Supreme Court on Banking Practices

The procedure adopted by banks after July 1985 was based largely on mark-up techniques with or without a buy-back arrangement. Consequently it was eventually declared un-Islamic by the Federal Shariah Court (FSC) in a judgment in November 1991. The government appealed against the Federal Shariah Court’s judgment to the Shariah Appellate Bench (SAB) of the Supreme Court of Pakistan. The Supreme Court too, in its historic judgment on December 23rd, 1999, rejected the government’s appeals and asked the government to remove all laws involving interest before June 30th, 2001 [SAB Supreme Court of Pakistan 2000: 468]. The Court declared many of the prescribed modes of investment and finance designed by SBP, and the practices of the commercial banks using these modes as un-Islamic. The judgment of the court concluded that:

1. All prevailing forms of interest, either in banking transactions or in private transactions fall within the definition of *riba*.
2. Any interest stipulated in government borrowings acquired from domestic or foreign sources are *riba* and clearly prohibited by the Holy Qur’an.
3. The present financial system, based on interest, is against the injunctions of Islam as laid down by the Holy Qur’an and *Sunnah*, and in order to bring it into conformity with the *Shariah*, it has to be subjected to radical changes.

The court asked the government to set up a Commission for Transformation of Financial System (CTFS) and for two task forces to be set up to plan and implement the process of this transformation. Thus, the CTFS was constituted in January 2000 by the SBP under the chairmanship of I.A. Hanfi, a former governor of the SBP. A task force was set up in the Ministry of Finance to suggest ways

in which interest could be eliminated from government financial transactions. Another task force was set up in the Ministry of Law to suggest amendments to the legal framework to implement the court's judgment. However the government, working through a public sector bank, went to court to ask for an extension of the date until 2006. The court gave only a year's extension to its earlier June 30th, 2001, deadline.

The government constituted a high level commission and a number of task forces and committees to study the prospects of transforming the interest based financial system of the time into a *Shariah* compliant system and to format the transformation plan.

However they all arrived at the obvious conclusion that the transformation of the financial system as a whole was not possible in the short term due to a variety of factors. In fact, the complexity of the branch networks of national, foreign and state-owned and private commercial banks, an absence of committed and sustained efforts, and a lack of genuine support from various segments of society resulted in the failure of Islamization process. Indeed, developing a successful, workable and complete model of Islamic banking was a complex and difficult task for the government, especially in the case a developing country like Pakistan. Therefore, it was decided in the year 2001 to compromise by promoting Islamic banking on a parallel basis with the conventional banking system.

The worse was yet to come. All the efforts that had been made to introduce *Shariah* compliant Islamic banking received a serious blow when on June 21st, 2002, while reviewing a petition by United Bank Limited (UBL), the Supreme Court's SAB set aside all the previous judgments in this regard, including its own historic decision of December 23rd, 1999, and the November 1991 decision of the Federal Shariah Court (FSC). Horrified by this turn of events, the Shariah Appellates Bench (SAB) of the Supreme Court asked the FSC to re-hear the original case. Since then, the case has been collecting dust in a long line of cases still waiting to be reviewed. Consequently, the efforts to transform the banking and financial institutions of Pakistan took a new turn, which in time lead the State Bank and other authorities to mark out a new strategy for altering the existing practices of the country's financial institutions.

It should be remembered throughout all this that the commandments and views of Holy Qur'an on the prohibition of *riba* are clear and unequivocal. Moreover, the constitution of Pakistan 1973, in its Article 227 states that all existing laws shall be brought into conformity with the injunctions of Islam as laid down in the Holy Qur'an and Sunnah. Article 37 of the same (1973) constitution dealing with the Principle of Policy states that it is the duty of the State to eliminate *riba* as early as possible. There is complete unanimity among all schools of religious thought that the term *riba* covers interest in all its manifestations.

2.5 Factors Involved in the Retardation of the Islamization Process in Pakistan

After carefully examining the Islamization process of the banking and financial institutions of Pakistan several factors can be summed up in the following order:

(a) The Government Administration

The significance of the government's part in establishing and overseeing the success of the new banking and financial system cannot be underestimated. Although the attempt at the Islamization of the economy was initially started under the umbrella of the constitution, the constitutional authorities were never persuaded to take the implications of these efforts seriously. On the one hand the government initially suppressed but subsequently responded to the emergence of Islamic law in Pakistan by declaring in the Supreme Court on February 10th, 1979, that the enforcement of an interest-free Islamic economic system would be completed within a three-year time frame. On the other hand this very same government on June 25th, 1980, limited the jurisdiction of Federal Shariah Court for a period of three years from entertaining any petition to consider fiscal issues including bank interest. This limiting of the jurisdiction of the Federal Shariah Court was subsequently extended for one year and then for another year. Yet again on March 2nd, 1985, the president of Pakistan promulgated the President's Order No. 14 of 1985 whereby this period was extended for a further 10 years.

It is significant that neither the government nor the central bank of the country (SBP) provided staunch leadership to motivate the conventional banks and other financial institutions to take bold and devoted initiative to get rid from the traditional interest-based banking practices.

(b) Absence of Authentic Political Support

The provision of an Islamic way of life for its citizens and the establishment of an Islamic economic and societal environment is the constitutional and legal responsibility of the government of Pakistan. With the exception of establishing the Council of Islamic Ideology, the government did not contrive firm provisions and effective strategic policies for facilitating the Islamization process of the economy. On one hand the government asserted its intention to eliminate interest from the economy, but on the other hand, it imposed a ten-year ban (from 1980 to 1990) on the Federal Shariah Court preventing it from issuing any verdict against interest based banking transactions [FSC Judgment on *Riba* 1991]. The subsequent government headed by Nawaz Sharif manifested a similar attitude except for its establishment of the Commission for Islamization of the Economy (CIE) in June 1991 to promote Islamic Banking. Furthermore, the ruling government of Nawaz Sharif challenged the 1991 FSC judgment on *riba* in the Supreme Court. The government contended that bank interest is not *riba* and that it was utterly impossible to run the economy without interest in present day circumstances [Mansoor and Bhatti 2006: 146].

(c) Lack of Professional Management in the Central Bank of Pakistan

Obviously the task of developing alternative techniques to interest-based banking, without any dislocation or chaos, is a very sophisticated operation requiring long-term planning and a sustained effort to see it through to completion. Having observed that the government was not showing any genuine interest in the project, the SBP did not feel a pressing need to devise any prudent policy for adopting an interest-free financial system. It did not establish any internal Islamic Shariah Board

(until the year 2001) for seeking guidance on Islamization policies. Neither did it take any serious measures for providing proper training to bankers on how to adopt interest-free banking.

(d) The Exploitative Socio-Economic Atmosphere of the Country

The socio-economic set of the country is beneficial for those who are powerful in term of political and wealth. A handful number of malpractice politician and bureaucratic families have monopolistic control of the state affairs. All major economic reforms to eliminate monopoly of these few people over the country's resources were not accompanied due to same malpractice politicians and bureaucrats. The Islamization of the banking and financial institutions measures were also not accompanied due to such malpractice attitude of the politicians. The Supreme Court during her hearing on *riba* recorded that since the malpractice of politician is prevails the interest-free banking cannot seek roots in Pakistan. The conclusion came into obvious form that Islamization of banking and financial sector could not succeeded in Pakistan because a fair and honest political and socio-economic setup, an essential prerequisite for the success of Islamic banking was not available.

3. Post Judgment Measures Taken for the Re-launching of Islamic Banking

Since the measures undertaken for the transformation of state owned banks from the existing conventional system to a *Shariah* compliant system could not be brought to a satisfactory outcome, it was decided to establish an independent statutory body for this purpose. The Commission for the Transformation of the Financial System (CTFS) was constituted in January 2000 in the State Bank of Pakistan [State Bank of Pakistan 2002: 192]. A task force was set up in the Ministry of Finance to work out ways to eliminate interest from the government's financial transactions. Another task force was set up in the Ministry of Law to draw up amendments to the legal framework to implement the court's judgment. The CTFS constituted a Committee for the Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for the new system. The First Interim Report of the CTFS submitted in October 2000, identified a number of prior actions which needed to be taken in order to prepare the ground for the transformation of the country's financial system. The Second Interim Report submitted in May 2001, identified major *Shariah* compliant modes of financing, mapped out their essentials, drafted a seminal law captioned 'The Islamization of Financial Transactions Ordinance, 2001', drew up model agreements for major modes of financing, and wrote guidelines for the conversion of the products and services of banks and financial institutions. The Final Report, made by combining the two above mentioned reports, was sent to the government in August 2001. The Commission also dealt with major products of banks and financial institutions, both assets and liabilities, such as letters of credit or guarantee, bills of exchange, term finance certificates (TFCs), State Bank's refinance schemes, credit cards, interbank transactions, underwriting, foreign currency forward cover and various kinds of bank accounts. This report contained a recommendation for forestalling willful default and safeguarding the banks, their depositors and their clients against

such losses. According to the Commission, prior/preparatory works for the introduction of a *Shariah* compliant financial system in brief included creating a legal infrastructure conducive to the working of the Islamic financial system, launching a massive education and training program for bankers and their clients and an effective campaign through media to create an awareness among the general public about the implications of an Islamic financial system.

3.1 Measures Taken by the Ministry of Finance

The Finance Minister in his budget speech for the FY2001-2002 declared the following:

“The government is committed to eliminating Riba and promoting Islamic banking in the country”. For this purpose a number of steps are under way which are:

1. A legal framework is being designed to encourage the practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations.
2. Consultations and exchanges are being undertaken with the governments of other Islamic countries and renowned institutions of Islamic learning in Middle-Eastern countries such as Al-Azhar University of Egypt, to learn more about their experiences and practices.
3. Amendments in the HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC will be a fully *Shariah* compliant institution, which will play an effective role not only in the promotion of Islamic financing methods but also in the development of the important housing sector.
4. *Shariah* compliant modes of financing like *musharakah* and *mudarabah* will be encouraged so that familiarity with and use of such products is enhanced and their adoption on a wider scale is made possible.

Furthermore, it is the government's intention to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors.

A committee has been constituted in the Institute of Chartered Accountants, Pakistan (ICAP), wherein the SBP is also represented, for the development of accounting and auditing standards for Islamic modes of financing [State Bank of Pakistan 2002: 192]. This committee is reviewing the standards prepared by the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) with a view to adapting them to our circumstances and if considered necessary, to proposing new accounting standards. The State Bank has also reviewed its forms of financial statements for banks in the light of AAOIFI standards. A new Islamic Banking Division has been established in the Banking Policy Department of SBP for the regulation and promotion of Islamic banking. Existing prudential regulations for banks have been reviewed by SBP for their application to Islamic banks.

3.2 Measures Taken at the State Bank of Pakistan

It was decided that the shift to an interest free economy would be made in a gradual and

phased manner so as not to cause any disruptions. The State Bank of Pakistan took the essential steps and adopted the following strategy to promote Islamic banking in Pakistan.

SBP expressed its commitment to introducing Islamic banking in the country on a parallel basis [SBP Annual report of 2001-2002: 194]. The following measures were taken in this regard:

1. For the establishment of Islamic banks in the private sector SBP issued detailed criteria for the setting up of a Scheduled Islamic Commercial Bank to conduct business based on the principles of the *Shariah*.
2. In order to promote Islamic Banking, the existing scheduled commercial banks were allowed to open subsidiaries for Islamic banking operations.
3. With the objective of promoting Islamic banking SBP prepared a detailed guideline for the opening of Stand-alone Islamic Banking branches by existing commercial banks.

Furthermore, SBP has taken a number of initiatives since this judgment:

4. A detailed set of criteria for the establishment of Islamic commercial banks in the private sector was issued in December 2001.
5. A new, fully dedicated Islamic bank, Meezan Bank Limited, has been issued a license and the bank has started its business.
6. In order to allow existing banks to set up subsidiaries for Islamic banking, draft amendments in Section 23 of the Banking Companies Ordinance 1962 have been submitted to the government for approval.
7. A new Islamic Banking Division has been established in the Banking Policy Department for the regulation and promotion of Islamic banking.
8. Existing Prudential Regulations have been reviewed by SBP for their application to Islamic banks, and revised regulations are being prepared.
9. The Export Finance Scheme of SBP is being revised to conform to a *musharakah* format.
10. Courses on Islamic economics, banking and finance have been included in the curricula of the Institute of Bankers in Pakistan.
11. The International Islamic University, Islamabad, has conducted a teacher training course on the Islamic Financial System in April 2002. SBP's staff along with the staff of other banks attended the course.
12. SBP has reviewed its forms of bank financial statements in the light of newly developed accounting standards.

A Shariah Board comprising two *Shariah* scholars and three experts in the fields and professions of banking, accounting and financial law has been established in the State Bank of Pakistan to advise on modes, procedures, laws and regulations for *Shariah* compliant Islamic banking.

3.3 The Present Picture of Islamic Banking in Pakistan

There are 6 full-fledged Islamic and 13 conventional banks conducting Islamic banking in Pakistan at present. The names of the six Islamic banks are: Meezan Islamic Bank, Al-Baraka Islamic Bank, Dubai Islamic Bank, Bank Islami Pakistan Limited, Emirates Global Islamic Bank

Limited and First Dawood Islamic Bank. According to the quarterly report of the State Bank of Pakistan, the total assets of these Islamic banks now stands at PRS 136 billion, the assets growth rate of Islamic banks is estimated at 10.5% over the period. The assets share of Islamic banking in the overall banking system is estimated to be 3.2% at present. The total of number of Islamic banking branches at Islamic banks and conventional banks is 173. These 173 Islamic banking branches count for less than 1.5% of more than 8500 banking branches of the country. The number of branches and the number of banks offering Islamic banking are tabulated as followings.

Table 1: Islamic Banks and Islamic Banking Branches in Pakistan

Name of Bank	Category	No. of Branches
Al-Baraka Islamic Bank	Islamic bank	11
Bank Islami Pakistan Limited	„	13
Dubai Islamic Bank Pakistan	„	15
Emirates Global Islamic Bank	„	6
First Dawood Islamic Bank	„	1
Meezan Islamic Bank	„	69
Subtotal: 6	A	115
Askari Commercial Bank	conventional bank	6
ABN AMRO Bank Limited	„	1
Bank Al-Habib	„	3
Bank Al-Falah	„	23
Bank of Khyber	„	5
Habib Bank Metropolitan	„	4
Habib Bank Limited	„	1
MCB Bank Limited	„	6
National Bank of Pakistan	„	1
Prime Commercial Bank Limited	„	2
Soneri Bank Limited	„	2
Standard Chartered Bank	„	3
United Bank Limited	„	1
Subtotal: 13	B	58
Total: 19	A+B	173

Source: State Bank of Pakistan *Quarterly Report* July.2007

According to the state bank of Pakistan's quarterly report of July 2007, total assets of these banking branches now stands for more than 136 billion Pak-Rupees. The assets growth rate of these banks is estimated more than 10% over the period. The assets share of Islamic banking in overall banking industry is more than 3.2%. These figures indicate that each Islamic banking branch posses more than double worth of assets as compared to conventional banking branch.

Table 2: Progress of Islamic Banks and their Market Share in Pakistan

Description	March-07	Dec-06	Dec-05	Dec-04	Dec-03
Total Assets	136	118	72	44	13
% of Banking Industry	3.2	2.9	2.1	1.4	0.5
Deposits	93	83	50	30	8
% of Banking Industry	3.0	2.8	1.9	1.2	0.4
Finance & Investment	78	72	48	30	10
% of Banking Industry	2.5	2.4	1.8	1.3	0.5

Source: State Bank of Pakistan *Quarterly Report* July, 2007

3.4 Factors Supporting the Development of Islamic Banking in Pakistan

(a) Decentralization of Administrative Power

The responsibility for the adaptation of the market economy, the decentralization or privatization of loss making state-owned financial enterprises and the task of establishing Islamic banks was transferred to the State Bank of Pakistan. The State Bank of Pakistan took the initiative to launch Islamic banking in gradual phases. The emphasis was to promote and establish new full-fledged Islamic Banks rather than continue the transformation of existing conventional banks towards Islamization. Since the year 2000, the State Bank of Pakistan has followed various strategies to promote Islamic Banking such as; (a) the setting up of the criteria for establishing independent Islamic branches or subsidiary branches of Islamic banking; (b) The formation of the Islamic Banking Division at the State Bank of Pakistan and; (c) The establishment of a Shariah Scholar Board at the State Bank of Pakistan. All these above measures have imparted a positive impact on the effective working of Islamic Banking.

(b) Commendable Developments in the Economy after the Year 2000

Despite a series of domestic and external shocks of an unprecedented nature, the economy of Pakistan has made commendable progress since the year 2000. It is a well-established fact that the decade of the 1990s was a lost decade for Pakistan. While many developing countries made substantial economic progress Pakistan lurched from one economic crisis to another mainly of its own making [Ashfaq 2004]. Commercial banks and other financial institutions became the instruments of political patronage and profit for certain sub-sections of society. The average economic growth was between 3-4% per annum. During the years 2000-2005 the average economic growth increased to 7-8% per annum. The depth and efficiency of financial intermediation in Pakistan has improved. The bank assets to GDP ratio rose from 49.1% in 1997 to 55.6% in 2005 and the deposit to GDP ratio – an indicator of the level of financial savings- rose from 38.7% in 1997 to 43.1% in 2005. More significantly, equity market capitalization grew from a mere 10.3% of GDP in 2000 to 37.1% of GDP in 2006.

(c) Participation and Sharing of Islamic or Religious Parties in Political Power

When Pakistan became an independent nation, the *Ulema* (Religious leaders or Muslim Scholars) did not wait long to demand their share of power in running the new state. Jamat-i-Islami made the achievement of an Islamic Constitution its central goal.

In February 1948, Maulana Maududi, while addressing the Lahore Law College, demanded that the Constitutional Assembly should unequivocally declare:

1. That the sovereignty of the State of Pakistan is vested in *Allah* and the government of Pakistan shall be only an agent to execute the Sovereign's Will.
2. That the Islamic *Shariah* shall form the inviolable basic code for all legislation in Pakistan.
3. That all existing or future legislation which may contravene, whether in letter or in spirit, the Islamic *Shariah* shall be null and void and be considered *ultra vires* (beyond the legal capacity) of the constitution.
4. That the powers of the government of Pakistan shall be derived from, circumscribed by and exercised within the limits of the Islamic *Shariah* alone.

On January 13th, 1948, Jamiat-al-Ulema-i-Islam, led by Maulana Shabbir Ahmad Usmani, passed a resolution in Karachi demanding that the government appoint a leading *alim* (Islamic scholar) to the office of *Shaikh al-Islam*, with appropriate ministerial and executive powers over the *qadis* (Islamic judges) throughout the country. On February 9th, 1948, Maulana Shabbir Ahmad Usmani, addressing the Ulema-i-Islam conference in Dacca, demanded that the Constituent Assembly "Should set up a committee consisting of eminent *Ulema* (Islamic scholars.) and thinkers... to prepare a draft for an Islamic state ... and present it to the Assembly".

The declaration of Pakistan as an Islamic Republic in 1953 was also the result of the struggle of these Islamic parties. All of the above and other Islamic parties also take-part in politics actively, and their share of power is increasing gradually. The struggles of these parties to establish an Islamic state is beginning to bear fruit now. The Islamization Program of Zia-ul-Haq, Islamization amendments in Pakistan's constitution, and the Islamization of the economy is the result of the efforts of these Islamic or religious parties.

(d) The Prudential Performance of Islamic Banks and the Risk Taking Attitude of Investors

When compared to conventional banks the performance of Islamic banks is more commendable because Islamic banks distribute higher profits. 80.9% of respondents said that Islamic banks distribute higher profits when compared to conventional banks in Pakistan [Hassan 2007: 210-17]. In same study we found that investors were prepared to take a risk in the case of Islamic banks, with 88.48% of respondents saying that they would continue their financial dealing with Islamic banks, even though the risk with these banks was higher than the conventional banks.

4. Conclusion and Expectations

Soon after the independence of Pakistan several efforts and strategic measures were taken to induce and implication the Islamic principles in state affairs, such as:

1. Efforts to introduce Islamic principles into the constitution.
2. At theoretical level, several debates were held focusing on the elimination of *riba* from the economy in these debated some unanimity was achieved.
3. At institutional level, a number of constituent bodies such as the Federal Shariah Court, the Commission for the Islamization of Economy and the Council of Islamic Ideology were formed to formulate the suggestions and recommendations for the elimination of interest from the economy.

Some important lessons have emerged from Pakistan's experience through the Islamization efforts of the 1980's. First, the policy of transforming the financial and banking sectors in at once or in one-step did not brought the desired results. Most of the measures were later reversed or, at least, further enhancement of the Islamization of the economy was halted. Second, decentralization or privatization of state owned banks and financial institutions was initiated and measures to establish a market economy were adopted. This policy helped the government to get rid of loss generating financial institutions and allowed it to concentrate on the process of Islamizing the economy. Third, an evolutionary (step-by-step) process, rather than a revolutionary (at once or sudden) approach was introduced in order to nurture the acceptability and development of an Islamic financial industry. The State Bank of Pakistan wisely adopted a gradual approach to establishing Islamic banking in Pakistan. Under this policy, Islamic banking is being promoted in parallel with the conventional finance industry, in an integrated, gradual and steady way. In addition, SBP allows conventional banks to set up Islamic banking subsidiaries or dedicated Islamic banking branches to offer a range of financial services. SBP has put into place a comprehensive and robust multi-tiered *Shariah* compliance mechanism to increase customers and investors confidence in the Islamic banking industry. The *Shariah* compliance mechanism has three main pillars: (i) a Shariah Board at SBP which approves policies and guidelines as well as fitting and proper criteria for its advisors; (ii) Shariah advisors in each bank to provide guidance to the bank staff and comfort to its customers on Islamic financial services; and (iii) a Shariah Audit System.

Although the process of re-launching Islamic banking in Pakistan started just four years ago the assets share of Islamic banks in the overall banking sector of Pakistan is remarkable. Now Islamic banks in Pakistan have more than 3.2% of the total deposits of the country's entire banking and financial sector. Islamic banks have more than 25000 borrowers now. These figures are noteworthy to show the prudential performance of Islamic banks because the risks involved are relatively different. Investors of Islamic banks face greater risks than investors of conventional banks. The progress of Islamic banks indicates that their popularity is growing and these banks are becoming attractive to investors. Furthermore, these banks have developed several new modes and instruments of finance and investments and now offer 75% of the financial instruments available at conventional banks. The present emphasis of the Shariah Advisory Board and the Islamic banks'

business development managers is on *Shariah* compliance. Keeping in mind the future of Islamic banks, it is hoped that this emphasis will shift to introducing a variety of financial instruments and modes of investment, and that continued financial development will increase the share of Islamic banks in banking and financial market. Presently, almost all Islamic banks are operating exclusively in the mega cities and big business centers of the country, but they are still noticeably absent from urban and rural areas where many potential customers with an urgent need for Islamic banking are waiting. It is suggested that opening operations in secondary and rural areas will foster the future development of Islamic banking.

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